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ABSTRACT

The investment committee of the college or university governing board is charged with determining, overseeing, and assessing the policies and processes by which institutional funds are invested. The committee has fiduciary duty to ensure that the terms of investment of donors' gifts are met and to maximize investment returns within an appropriate range of risk. Committee structure is determined by how the committee will work with the institution's administrative staff (chief executive, investment management staff, and consultants) and carry out its basic responsibilities. Committee responsibilities include: setting investment policy, managing asset allocations, reviewing investment results and investment manager performance, reviewing expenses, overseeing accounting and financial reporting, and monitoring proxy voting and social issues. The committee need not meet more than 4 times a year. Special agendas may be needed for new developments, such as debt financings, disposal of large stock gifts, or decisions to change asset allocations. To be judged successful, the committee must meet its spending-rule goals and achieve investment results that compare favorably with other institutions. (MSE)

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BOARD BASICS

EFFECTIVE COMMITTEES

THE INVESTMENT COMMITTEE

BY JOHN H. BIGGS

HE 030 562

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The Investment Committee

In the process of seeking philanthropic gifts, colleges and universities frequently accumulate large sums of money they must wisely invest. Usually, institutions hold various funds over long periods of time—in some cases, effectively into perpetuity. As a consequence, trustees play an especially useful and significant role in determining, overseeing, and assessing the policies and processes by which such funds are invested.

Trustees have a special fiduciary duty to ensure that all funds donors give to the institution are invested in a manner that meets the terms of the donor's instructions. At the same time, the goal is to maximize the returns to the institution within an appropriate amount of risk. Different kinds of funds require different kinds of investment policies, and an investment committee may employ various strategies for each investment category.

Trustees with financial backgrounds in investments, banking, or corporate management can help the governing board determine its investment policies and practices, but all trustees share equal responsibility for them.

Committee Charge

It is not always obvious what an investment committee should be charged to oversee. A college or university may have many different kinds of investable funds. Clearly, such funds include the school's endowment, but they also might involve operating funds, temporarily restricted funds, state allotments awaiting use, or funds in a state institution that are segregated for specific research purposes. It is essential for trustees to clearly understand the interrelationship between *spending* from investment funds, *budget practices*, and *investment policy*.

THE PRIMARY ISSUES CONCERNING COMMITTEE STRUCTURE INVOLVE HOW THE COMMITTEE WILL WORK WITH THE INSTITUTION'S ADMINISTRATIVE STAFF AND HOW IT WILL CARRY OUT ITS BASIC RESPONSIBILITIES.

Because of the nature of the skills their fiduciary responsibilities require, investment committee members also might be assigned to handle arrangements for any debt-based financing.

The investment committee frequently suggests or reviews the institution's "spending rule," although this could more directly interest the budget committee. The spending rule stipulates how much "income" the institution may derive from the endowment for use in each year's budget. If the investment committee believes the spending rule is excessive, it can play an especially important role for the board in testing the future implications of the rule. For example, a requirement that the institution spend a large amount of funds each year from income earned on its endowment might force a riskier investment policy than the board would tolerate.

In large institutions, the investment and budget committees are distinct entities, with the latter concentrating on annual (and outyear) budget oversight. For schools without large investments to oversee, a better arrangement may be to have a finance committee that oversees both investments and budgets. Such a unitary group can best coordinate the institution's finances without devoting an excessive amount of time to the demands of an elaborate investment policy.

In any event, an important first-step in an institution's corporate governance is for the entire board of trustees to define clearly the responsibilities of its finance committee or, alternatively, its investment and budget committees.

Committee Structure

The primary issues concerning committee structure involve how the committee will work with the institution's administrative staff and how it will carry out its basic responsibilities.

1. The Role of the Chief Executive. Assuming the board resolves the governance question and creates an investment committee with a defined area for oversight, the committee should think through the functions of the institution's chancellor or president in relation to the investment committee. In a typical *for-profit* corporate board, the chief executive usually takes responsibility for the corporation's investment funds. These include pension-plan assets, temporary balance-sheet investments, and more fundamentally, the basic business assets. On the other hand, in a nonprofit institution the board may take direct charge of the investment funds, to the point where the president or chancellor often is excluded altogether from the decision-making process. One would think many boards might reexamine this model, even as corporate America takes more seriously the responsibilities of corporate boards and executive management. (See the excellent discussion of the differences between for-profit and not-for-profit boards in William G. Bowen's book, *Inside the Boardroom: Governance by Directors and Trustees*).

2. The Role of Investment Management Staff. Management competence in overseeing investment funds is essential. The field of investment management is difficult and very technical, and the most competent people usually are well compensated. Accordingly, many colleges and universities have avoided building their own internal staffs, or they have found they are unable to find skilled staff, especially at salaries they reasonably can afford.

Perhaps the most fundamental question for the investment committee is to determine what kind of management to employ. At one extreme, an investment committee with a small portfolio might outsource all work to an investment advisory firm or even to several mutual funds. At the other extreme, the institution might employ a staff of equity and fixed-income experts to select all investments. Frequently, an institution will do this under the aegis of a separate corporate entity. Most institutions fall somewhere in between, with a small internal staff consisting of a single treasurer or a treasurer with an investment accounting staff. Their job is to help select outside investment managers, to oversee the financial accounting

and reporting of funds, and to report to the investment committee on the investment manager's performance relative to benchmarks and compliance with the institution's investment policy.

To some extent, the degree of investment-policy sophistication and the expectations for the internal management staff are linked: An aggressive, complex series of policies requires a more skilled staff than a relatively simple and mainline approach. Few institutions can afford to hire a sophisticated in-house investment team.

3. Employing Outside Services. Excellent services exist for all aspects of college investment management. Many major banks offer custodial and master trust services, which provide the accounting for and performance reporting of multiple managers, money managers for any asset class the committee might select, professional advisers who can consult on asset-allocation decisions and on selection of actual money managers, and finally, auditing firms to make sure the accounting controls and financial management meet reasonable standards.

In no case should the committee allow consultants to dictate policy. The consultants should *advise* the committee about appropriate investment policies and benchmarks that take into account institutional needs and the efforts of peer institutions.

Committee Responsibilities

1. Setting Investment Policies. Once the governing board makes its broad charge to the investment committee and an appropriate financial-management structure is in place, the committee can formulate investment policies. Endowment fund policies usually have a broad, long-term goal to preserve the purchasing power of the endowment while supporting the annual spending rule the budget committee has adopted. Accordingly, if this spending rule is 5 percent of current or average market value of the endowment, then the goal would be to earn 5 percent plus inflation over a specified time.

ONCE THE GOVERNING BOARD MAKES ITS BROAD CHARGE TO THE INVESTMENT COMMITTEE AND AN APPROPRIATE FINANCIAL-MANAGEMENT STRUCTURE IS IN PLACE, THE COMMITTEE CAN FORMULATE INVESTMENT POLICIES.

Two problems exist with the foregoing classic goal statement. First, it is extremely difficult to define with any precision the kinds and mix of assets that reliably can achieve that goal, even over an extended period of five or ten years. Second, such a goal does not reflect the competitive world in which higher education exists. Suppose a committee regularly could meet the goal over a ten-year period, but other institutions following a more aggressive policy exceeded the return by 2 percent or 3 percent a year. Over a ten-year period, this difference would seriously impair the institution's ability to maintain a competitive academic program or tuition rate (depending on how the budget committee deals with the endowment income shortfalls). The committee should use a consultant to advise how peer institutions have dealt with these issues.

Although such "absolutist" goals (such as X percent plus inflation) may be clarifying to the institution, they should be tempered by a strategy that does not allow the institution to trail far behind the performance of its peers when the school cannot afford to meet its goal. For example, if most higher education endowments invest half their funds in stocks, the committee should consider very cautiously a decision to invest in no stocks or 100 percent in stocks. The committee should not exclude such a decision, but it should demand real conviction and consensus of the entire board before taking such an extreme position. A better operating goal might simply be to say the school wants to be in the upper quartile of any distribution of competitors' performance over a five-year or ten-year period.

For nonendowment investment funds, the goals usually are much more short-term and easier to define: Money-market returns probably are right for funds to be expended within a year, and funds with a two-year horizon might seek the extra return of slightly longer maturities but without much risk. It is important, however, that investment committee members look carefully at the pattern of use of such funds over many years. For instance, if a core of funds is always renewing and there is a minimum level that the funds never break, then a longer term strafegy for such core funds can produce significant extra return to the annual budgets (but with some carefully considered risk).

For longer term funds—that is, for endowments—*asset allocation* is by far the most important decision the investment committee will make. Over time, 90 percent of variation in returns will be determined by asset class allocation, with the small balance affected by the ability of the fund manager and the selection of the specific assets.

The usual analytic model starts with equity versus fixed income, with ranges from 25 percent-to-75 percent to 75 percent-to-25 percent. Most institutions have equity positions between 50 percent and 75 percent. The percentage of equities or equity-line assets should be the result of the needs and risk tolerance of the institution. Again, many institutions use an adviser to assist in this critical decision.

Once the committee designates the percentage of equities, it needs to determine what types of equities to purchase. The obvious first category is domestic U.S. stocks, with subdivisions of large, mid, and small "caps" (or size of stock). The easiest first cut, however, is to define a "benchmark" return, which customarily has been the Standard & Poor's 500. Many endowments are turning to broader benchmarks, such as the Wilshire 5000 or Russell 3000 indicies, which cover all sizes of stocks.

International stocks are the second customary category. Investors reason they can offset risks peculiar to the U.S. markets by holding some foreign stocks. Ordinarily, allocations of equity positions are 75 percent-to-80 percent U.S. and 20 percent-to-25 percent foreign, as opposed to true "global" allocation, which is weighted in proportion to world securities outstanding and probably would require 60 percent-to-70 percent foreign investments.

ONE SPECIAL WARNING AGAINST A FREQUENT OCCURRENCE ON INVESTMENT COMMITTEES: BEWARE OF INVESTING IN A COMPLEX PROGRAM ONLY ONE COMMITTEE MEMBER PROPOSES AND UNDERSTANDS.

A few investment committees have earmarked portions of their endowments to such other equity classes as real estate, venture-capital and hedge-fund partnerships, and other "alternative" equity investments. The argument for purchasing such assets is that they will march to their own drummer, independent of the major securities markets. On the other hand, selecting and overseeing these assets requires a great deal of skill. An investment committee should approach them cautiously unless able internal staff exists to manage such a portfolio.

One special warning against a frequent occurrence on investment committees: Beware of investing in a complex program only one committee member proposes and understands. Although such investments can be quite successful, boards have high turnover rates. If the deal's sponsor departs, less informed successors can seriously mismanage the shrewd investment. This warning especially applies to "alternative" equity investments, but general principle dictates no single trustee should have unilateral authority over investments. The investment committee must act as a team under the direction of a chair who actively solicits opinions and encourages discussion of conflicting positions.

There usually is a fair amount of discussion about attributes of the fixed-income "class," such as maturity or duration of the portfolio and the percentage of the class devoted to one holding. A few committees have steered some endowment funds into foreign bonds, but they face confusing and difficult judgments about currency risks and causes of interest-rate movements in other countries. Other committees have invested endowment funds in pools of mortgage loans related to real estate, but such investments involve risks only experts should manage.

UNDOUBTEDLY, MANY SUCCESSFUL ACTIVE-MANAGEMENT STRATEGIES EXIST, BUT GIVEN THE HISTORY OF FAILURE, WISE INVESTMENT COMMITTEE MEMBERS WILL LISTEN TO PRESENTATIONS OF ALL ACTIVE STRATEGIES WITH SKEPTICISM.

2. Managing Asset Classes. The investment committee has played its most important role in choosing the asset classes in which to invest. But the most difficult and time-consuming role is deciding how to invest each asset class. For many investment committee members, this is the most interesting part of the committee assignment. Again, remember that the payoff to the institution from any individual asset is likely to be relatively small and in many cases can produce a loss. Even though the loss may be fairly small, the gains are likely to be small as well.

An important but often overlooked question is whether assets should be "actively" or "passively" invested. Many committees leap immediately into the question of which active asset managers to use. Instead, the committee might want to start with a simple "indexing" approach and then move to more sophisticated "active" management only when it fully comprehends the risks and potential for extra returns of an active management program.

It is quite simple, and usually very successful, for the committee to index even a complex array of asset classes. Several major banks and money-management firms offer such arrangements. For example, many firms easily can provide indexed funds for the entire U.S. market (indexed to the Wilshire 5000 or Russell 3000) or to major segments of the U.S. market (S&P 500 or a mid-cap or small-cap index). Foreign stock markets can be indexed to the market-weighted Morgan Stanley EAFE index and even to sectors (Europe, Asian Rim, Emerging Markets, or individual

countries). Bonds can be indexed to a variety of choices (the broad bond-market index, corporate only, or government only). And even real estate can be roughly indexed by buying a pool of Real Estate Investment Trusts, or REITs.

There are several advantages of the totally indexed approach:

- It keeps the committee focused on the main question—asset class allocation.
- It is extremely inexpensive—the management charge is less than 10 basis points (that is, 0.1 percent), and there is little brokerage expense because there is no need for trading.
- Historically, the performance of index funds in each asset class has been excellent (surpassing in most time periods the results of professionally managed funds that have significantly higher expenses).
- Indexing is easy to administer and manage and is well within the capacity of a senior staff financial officer who may have other financial or administrative duties and responsibilities.

If the investment committee decides to seek higher returns through "active" management, advocates of such investing must be able to prove they are likely to beat the indexing approach. In a sense, this becomes the active account's benchmark—or as investment professionals often say, "their cost of money." Trustees should be careful not to expose the endowment to an unacceptable risk level of *under*performance.

Undoubtedly, many successful active-management strategies exist, but given the history of failure, wise investment committee members will listen to presentations of all active strategies with skepticism. They also will demand performance objectives that clearly relate to the underlying benchmarks.

Active strategies are innumerable. Most commonly, investment committees use outside managers who select stocks or bonds for an assigned portfolio with the goal of beating a designated benchmark. The committee should look closely at the manager's record, remembering that such managers are handicapped from the beginning by their management fee (which can range from 20 basis points to several hundred) and the brokerage fees for their active trading of the account. Other active strategies include such alternative investments as real estate—ranging from diversified REITs to individual properties—venture capital closed-end partnerships, and hedge-fund shares.

Another active strategy, pursued only by the very largest and most sophisticated investment programs, involves in-house direct management of the assets. The difficulties of such an active program are obvious. The advantages, however, can be great: The institution has a greater ability to limit costs, control risk, and pursue innovative ideas. In many institutions, nonendowment funds are administered internally, because the investments are primarily low risk, short term, and highly creditworthy.

3. *Reviewing Expenses.* An investment committee should review the level of expenses its program incurs at least every year. Such expenses should not be limited to internal management costs but also should include fees paid to outside active managers, custodial and reporting fees to banks, and any fees paid to general-purpose consultants who assist the committee. The committee also might consider brokerage fees, although many committees think of these as directly linked to investment performance. Committees should be wary of the practice of some money-management firms to use "soft dollars" for their own expenses or for elaborate "educational" programs for trustees. (This occurs when brokerage is directed to a particular firm that will give the institution either a credit in dollars or toward other services.) Ultimately, such funds are equivalent to hard-dollar direct expenditures, but they are disguised by brokerage sales. It is surprisingly difficult to compare endowment performance across institutions since so few know what their expenses are.

4. *Overseeing Accounting and Financial Reporting.* An often neglected aspect of investment management is the basic accounting and financial reporting structure for the various investment funds—endowment funds, the current fund, and restricted research funds. It may be the case in certain institutions that the investment committee's most important contribution is to make sure appropriate arrangements are in place so that donor preferences are recognized and investment management can be carried out in accord with those preferences.

For example, all endowment funds should be commingled in one fund, if possible, with a single set of investment policies and appropriate valuation dates. Depending on the amount and frequency of contributions, valuation should be at least quarterly, or more likely monthly and even daily, so that new contributions and withdrawals can be properly credited and debited. Staff should establish custodial and master-accounting

arrangements, with a bank or other service institution taking responsibility for such custody. Of course, separation of accounting functions from investment-management functions is necessary. The committee also must articulate investment policies and accounting arrangements for current funds and restricted funds with accounting and reporting arrangements for each type of account. An institution can earn substantial extra returns by pooling such funds properly and taking into account investment opportunities that large-size pooled funds offer.

The investment committee needs to work with the institution's external auditors and internal financial management staffs to ensure that accounting and reporting policies serve the committee's analytic needs. Sound and appropriate policies also permit necessary GAAP (generally accepted accounting principles) reporting and internal budget management. This may sound easy to do until one copes with the unusual accounting formats of the GAAP statements as well as the more performance-oriented methodology of investment reporting. Internal controls of investment funds and cash flow may rely more on the GAAP statement funds than on the portfolio-management reports, yet the latter are often the only reports the investment committee will see.

5. *Monitoring Proxy Voting and Social Issues.* Campus concerns ebb and flow about investments in corporations that may violate the social conscience of one group or another. In the past, investments in American companies that conducted business in South African aroused great interest. More recently, some groups have raised concerns about endowments' holdings in tobacco companies.

A basic obligation of any institutional investor is to vote on proxies presented at annual meetings of portfolio companies. Such proxy resolutions usually are "financial" in character, involving approval of stock options, ratification of the selection of the external auditor, or endorsing various corporate changes. The investment committee can instruct its institutional managers to take responsibility for such matters. In the case of index funds, these outside managers have developed a procedure for voting, since it is a requirement for pension funds under federal law.

The more difficult proxy resolutions for academic institutions involve corporate governance and social issues. Such resolutions involve an array of complex questions that an investment committee cannot hope to solve in a single meeting. In reality, most investment committees ignore such resolutions unless they are challenged by a campus group.

A more careful procedure would assign voting responsibility to a third party and require annual reports to the committee on the key issues and how they were voted upon. The committee could intervene and change subsequent voting policy if it wished. Such a third party might be the custodian, a money-management firm, or a consultant. Excellent research materials are available through the Investor Responsibility Research Center, a nonprofit office established for endowments and pension funds in response to concerns regarding divestment in South Africa.

Another approach is to assign responsibility for proxy voting to a special committee either of the board or jointly with faculty and other institutional constituencies. This responsibility can be time consuming and contentious, since it involves difficult political and moral questions. It also may involve issues of academic freedom, because a small committee might well be voting on major social issues in the name of the entire institution.

Committee Agenda

The investment committee should not need to meet more than four times a year. It should review the asset allocation of the various investment programs and fine-tune the distribution of assets among managers. Perhaps twice a year the agenda should include performance data for each asset class and active managers, if any. More frequent meetings and reviews can tempt committee members to micromanage and develop an inappropriately short time perspective.

In all cases, committee members should insist on receiving items in formats they can understand for each type of investment program—with three-year, five-year, and ten-year performance numbers for such long-term programs as endowments and perhaps quality analyses for short-term investment programs for operating funds. Special agendas may be needed for such new developments as debt financings, disposal of large stock gifts, or decisions to change asset allocations.

Conclusion

There are few areas within higher education governance in which the business and investment backgrounds of trustees can make a greater contribution than in investment management of an institution's endowment and other funds. The investment process comprises a complex mix of accounting, financial reporting, and significant investment-policy issues. Trustees with such backgrounds will recognize the many nuances and careful judgments required to carry out the purposes of the investment committee.

For an investment committee to be judged successful, it must meet its spending-rule goals and achieve investment results that compare favorably with those of peer institutions. The continuing oversight of investment strategies and the occasional adjustment of asset categories are the ongoing responsibility of the committee. The committee should use staff, the board, and external resources—bank custodians, advisers, and investment managers—to help improve the institution's financial assets.

Resources

Bowen, William G. *Inside the Boardroom: Governance by Directors and Trustees*. New York: John Wiley & Sons, 1994.

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Malkiel, Burton G. *A Random Walk Down Wall Street*. Boston: W. Norton, 1996.

Spitz, William T. *Selecting and Evaluating an Investment Manager* (from the "Financial Management Guide Book Series"). Washington, D.C.: National Association of College and University Business Officers, 1992.

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BOARD BASICS

This publication is part of an AGB series devoted to strengthening the role of key standing committees of governing boards. Several assumptions underpin the series:

- The work of boards should be accomplished in committee. An effective committee system will enhance the productivity of full board meetings.
- The committee structure of any board should mirror the full range of its responsibilities as a legal, corporate entity. That is, the committee organization should cover the oversight roles expected of trustees.
- Although there is no optimum committee system, certain principles and procedures should prevail: The board's bylaws or other operating policy should include a clear, comprehensive statement of responsibility for each standing committee. Each committee should be staffed by an appropriate administrative officer; a trustee or regent should serve as chair. No trustee should serve on more than two active committees, preferably one—excluding the executive committee.
- Before scheduled meetings, each committee member should receive a concise, well-conceived meeting agenda and relevant background information prepared by the committee chair and staff. Committees are responsible for recommending decisions and actions to the full board.
- As committee members seek additional information to fulfill their responsibilities, it is important to strike a balance between "too much" and "too little." Committee members must guard against requesting overly detailed information to avoid the appearance of becoming embroiled in administration or overburdening it. Before members make information requests, perhaps they would be well-served by asking if all such requests contribute to the committee's and the board's responsibilities for reviewing, setting, or approving institutional policies.

The *Effective Committees* set of booklets comprises publications on the following committees: investment, buildings and grounds, academic affairs, student affairs, finance, development, trustees, audit, and executive. It is part of the AGB **Board Basics Series**. AGB and the authors welcome comments and suggestions to improve this publication and others in the series.

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